THE STATE LOTTERY COMMISSION OF INDIANA

ANNUAL FINANCIAL REPORT FOR THE YEARS ENDED JUNE 30, 2004 AND 2003

AND INDEPENDENT AUDITOR'S REPORT

THE STATE LOTTERY COMMISSION OF INDIANA

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INDEPENDENT AUDITOR'S REPORT

TO THE STATE LOTTERY COMMISSION OF INDIANA
AND THE STATE BUDGET AGENCY OF INDIANA

We have audited the Statements of Net Assets of the State Lottery Commission of Indiana as of June 30, 2004 and 2003 and the related Statements of Revenues, Expenses and Changes in Net Assets and Cash Flows for the years then ended. These financial statements are the responsibility of management and the Commissioners of the State Lottery Commission of Indiana. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial statement audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform our audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the State Lottery Commission of Indiana as of June 30, 2004 and 2003 and the results of its operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis and Required Supplementary Information, as listed in the table of contents, is not a required part of the basic financial statements but is supplementary information, required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquires of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued a report dated September 9, 2004 on our consideration of the State Lottery Commission of Indiana's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

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Oak Brook, Illinois
September 9, 2004

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THE STATE LOTTERY COMMISSION OF INDIANA
MANAGEMENT DISCUSSION AND ANALYSIS

The management of The State Lottery Commission of Indiana offers readers of the Commission's annual financial report this narrative overview of our performance during the fiscal years ended June 30, 2004 and 2003. Please read it in conjunction with the financial statements, which follow this section.

FINANCIAL HIGHLIGHTS

- Fiscal year 2004 ticket sales surpassed $734 million, an increase of $70 million over fiscal year 2003. Fiscal year 2003 ticket sales were $664 million, an increase of $38 million over fiscal year 2002.
- FY04 operating expenses increased by $47 million. Of this increase, lottery game prizes increased by $40 million and retailer commissions increased by $5 million. During FY03 operating expenses increased by $29 million, including a $25 million increase in prizes and $2 million increase in retailer commissions.
- FY04 Net Income of $198 million and FY03 Net Income of $174 million represent increases of $24 million and $8 million respectively over the previous fiscal years.

OVERVIEW OF THE FINANCIAL STATEMENTS

The State Lottery Commission of Indiana is accounted for as an enterprise fund, reporting transactions using the accrual basis of accounting similar to a private business entity. This discussion and analysis is intended to serve as an introduction to the Commission's financial statements, along with corresponding note disclosures and other supplementary information.

By law, the Commission is required each quarter to transfer all of its surplus revenues to the state of Indiana. As a result, the net assets of the Commission consist only of an amount set aside for the future cash flow needs of the Commission. To assess the Commission's financial position and financial health, the reader of these statements should pay particular attention to changes in the components of assets and liabilities as set forth in the Statement of Net Assets, and in changes in operating revenues, expenses and distributions as set forth in the Statement of Revenues, Expenses and Changes in Fund Net Assets. In addition, the Statement of Cash Flows is intended to provide information about the cash receipts, cash payments and net changes in cash resulting from operations, investing, and financing activities.

FINANCIAL ANALYSIS OF THE COMMISSION

Net Assets and Change in Net Assets

Net assets represent the difference between total assets and total liabilities. Because the Commission is required by law to make quarterly transfers of its surplus revenues to the state of Indiana, change in net assets does not reflect the results of the Commission's operating activities.

FINANCIAL ANALYSIS OF THE COMMISSION (Continued)

Net Assets and Change in Net Assets (Continued)

Table 1
Net Assets
(in millions of dollars)

	June 30, 2004	2003	2002
Current assets	$ 98	$ 88	$ 87
Restricted assets	10	11	11
Long-term investments	57	58	51
Capital assets (net of accum.depreciation)	4	5	1
Total assets	169	162	150
Current liabilities	108	103	94
Long-term liabilities	56	58	51
Total liabilities	164	161	145
Net assets			
Unrestricted	1	(4)	4
Invested in capital assets	4	5	1
Total net assets	$ 5	$ 1	$ 5

Assets

An FY04 increase in assets was primarily the result of increased cash and cash equivalents on hand as of June 30, 2004 due to higher ticket sales and accelerated collections from retailers during the fourth quarter.

In FY03 long-term investments increased by $7 million to $58 million. The increase represents the value of U.S. Treasury obligations purchased to fund six additional deferred prizes awarded during the year. Also in FY03 capital assets net of accumulated depreciation increased 230% to $4.7 million. The purchase of pull tab vending machines and computer hardware upgrades during the year accounted for the majority of this increase.

Liabilities

Current liabilities increased $5 million to $108 million in FY04. Of this amount, the current portion of accrued prize liability increased by $9 million and distributions of surplus revenues payable to the state of Indiana decreased by $4 million. The $9 million increase in accrued prize liability includes a $2.3 million Hoosier Lotto jackpot prize awarded in March, 2004 but not claimed as of June 30. Prize money accrued for a Hoosier Lotto jackpot not awarded as of June 30 and prize money accrued for scratch game winners increased as well. The $4 million reduction in distributions of surplus revenues payable

FINANCIAL ANALYSIS OF THE COMMISSION (Continued)

Liabilities (Continued)

to the State of Indiana compared to FY03 is the result of a FY03 fourth quarter transfer to the state of Indiana in excess of FY03 fourth quarter net income.

FY04 long-term liabilities decreased by 3% to $56 million as payments to prior years' winners exceeded the value of one additional deferred prize was awarded during the year.

In FY03 current liabilities rose by $9 million to $103 million. This is due primarily to increases in distributions payable to the state of Indiana, reflecting higher FY03 fourth quarter revenues compared to FY02 as well as FY03 transfers in excess of surplus revenue.

FY03 long-term liabilities increased by 13% to $58 million compared to $51 million in FY02. The increase represents the present value obligation of six additional deferred prizes awarded during the year.

Net Assets

Net assets consist of unrestricted income retained for the future cash flow needs of the Commission and capital assets. The Commission's total net assets at June 30, 2004 and 2003 were $4.9 million and $1.3 million respectively.

FY03 unrestricted net assets were $3 million less than either FY04 or FY02, reflecting the Commission's FY03 fourth quarter transfer of surplus revenues to the state in excess of net income recorded during that quarter. The Commission's investment in capital assets in FY04 and FY03 amounted to $4 million and $5 million respectively, net of accumulated depreciation. Apart from the routine purchase of replacement vehicles for Lottery Sales Representatives during the year, there were no significant investments in capital assets during FY04. The FY03 total increase in capital assets over FY02 was $3 million. The increase was primarily the result of the acquisition of pull tab vending machines for deployment at lottery retailers as well as computer hardware upgrades. Additional information on capital assets can be found in note 3 to the financial statements.

FINANCIAL ANALYSIS OF THE COMMISSION (Continued)

Ticket Sales and Prize Expense

Ticket Sales

Table 2
Sales and Prize Expense
(in millions of dollars)

	Scratch			Pull Tab		
	2004	2003	2002	2004	2003	2002
Net Ticket Sales	$ 422	$ 386	$ 353	$ 19	$ 19	$ 1
Game Prizes	274	246	219	12	13	-
Gross Margin	$ 148	$ 140	$ 134	$ 7	$ 6	$ 1

	Powerball			Hoosier Lotto		
	2004	2003	2002	2004	2003	2002
Net Ticket Sales	$ 154	$ 128	$ 132	$ 70	$ 59	$ 64
Game Prizes	74	59	63	37	32	33
Gross Margin	$ 80	$ 69	$ 69	$ 33	$ 27	$ 31

	Daily 3 and 4			Lucky 5		
	2004	2003	2002	2004	2003	2002
Net Ticket Sales	$ 62	$ 62	$ 64	$ 8	$ 9	$ 9
Game Prizes	28	29	34	4	5	4
Gross Margin	$ 34	$ 33	$ 30	$ 4	$ 4	$ 5

	Max 5			Total		
	2004	2003	2002	2004	2003	2002
Net Ticket Sales	$ -	$ 2	$ 4	$ 735	$ 665	$ 627
Game Prizes	-	1	2	429	385	355
Gross Margin	$ -	$ 1	$ 2	$ 306	$ 280	$ 272

Table 2 compares FY04, FY03 and FY02 sales, prizes and gross margin for each lottery game category. FY04 sales increased in the scratch, Powerball and Hoosier Lotto product lines. FY03 sales increased in the scratch and pull tab product lines and decreased in all of the draw games. Gross margins generally increased or decreased relative to changes in game sales.

The FY04 and FY03 increases in scratch ticket sales reflect the continuation of the Commission's strategy to increase play in the higher price pointed games. Beginning in fiscal year 2002, the Commission increased placement of the $2 and higher price point games in retail locations, focused advertising on the $2 and higher price point games, and increased the prizes paid out on those tickets. These strategies resulted in greater play in the price pointed games, and a corresponding increase in sales.

FINANCIAL ANALYSIS OF THE COMMISSION (Continued)

Ticket Sales (Continued)

Pull tab ticket sales increased significantly during FY03 when the Commission offered pull tab vending machines to its retailers in order to improve inventory control. 700 pull tab vending machines were placed in retail locations during fiscal years 2003 and early 2004. FY04 sales remained stable compared to FY03.

Powerball is a multi-state lotto game offering large jackpot prizes. The Commission participates in this game along with 29 other United States lotteries, including the Virgin Islands. Sales in FY04 increased by $26 million due to multiple jackpots in excess of $150 million during the year. FY03 sales decreased from FY02 despite a record $315 million dollar jackpot.

Hoosier Lotto is a smaller lotto game available only in Indiana. Sales increased during FY04 by $11 million due primarily to a $20.5 million jackpot during the first quarter. Apart from this single occurrence, we expect Hoosier Lotto to experience minor sales decreases. As a mature game we expect sales at given jackpot levels to continue on a slow, steady decline. Additionally, historically low interest rates have resulted in a lower advertised jackpot for this game.

Daily 3, Daily 4 and Lucky 5 are all daily draw games with stable or slightly decreasing sales levels. However, because prize expenses also decreased in FY04 and FY03, these games have been slightly more profitable than in the previous fiscal years.

The Max 5 game was ended in January of 2003. Max 5 had a successful launch with excellent sampling by players via a free ticket coupon distributed by the Commission. However, Max 5 game was not sufficiently profitable to justify its continued inclusion in the Commission's draw game mix.

Prize Expense

In general, prize expense by game will increase or decrease from year to year in proportion to the increase or decrease in ticket sales for the corresponding game. However, prize expense can also be impacted by the luck of the draw or by changes to the game design. Also, prize expense for the Hoosier Millionaire game show is unrelated to ticket sales.

Total prize expense in FY04 of $436 million represents a 10% increase over FY03 prize expense of $396 million. FY03's total prize expense also increased by 7% to $396 million. These increases are consistent with increases in ticket sales during these same periods. Notable variances in prize expense are discussed below.

FY04 scratch game prize expense increased 11% while scratch game sales increased by 9%. FY03 scratch game prize expense increased by 12% while scratch game sales increased by 9% These trends reflect a heavier concentration of sales in products with higher price points, which pay out more in prizes than games with lower price points. The increases in scratch game prize expense were more than offset by the corresponding increases in scratch game sales, resulting in overall higher gross margins.

FINANCIAL ANALYSIS OF THE COMMISSION (Continued)

Prize Expense (Continued)

Daily 3, Daily 4 and Lucky 5 prize expense increases or decrease as a percentage of sales due to payout variations that result from fixed prize games. Therefore, gross margins may increase or decrease regardless of changes in sales levels.

The Hoosier Millionaire game show was reformatted in May, 2003. As a result of this change, FY04 game show prize expense decreased by 47% to $6 million compared to FY03.

Other Expenses

Table 3
Other Expenses for the year ended June 30,
(in millions of dollars)

	2004	2003	2002
Advertising & Promotions	$ 9	$ 10	$ 10
Retailer commissions	50	46	43
Other game expenses	16	15	15
Ticket printing costs	7	6	5
Other operating expenses	18	17	17
Total other expenses	$ 100	$ 94	$ 90

Higher retailer commissions represent the majority of the increase in Other Expenses. Retailer Commission Expense consists primarily of a 5.5% scratch game sales commission, a 6% draw game sales commission, a 1% cashing commission, and a retailer incentive bonus paid on scratch and pull tab game sales. The retailer commission increases are commensurate with increases in overall ticket sales.

Other Income

Table 4
Other Income for the year ended June 30,
(in millions of dollars)

	2004	2003	2002
Interest income	$ 0.9	$ 1.1	$ 2.3
Net increase/(decrease) in fair value of investments	(1.3)	2.3	0.3
Interest accretion	(1.2)	(4.9)	(3.0)
Other income	2.7	2.7	2.8
	$ 1.1	$ 1.2	$ 2.4

FINANCIAL ANALYSIS OF THE COMMISSION (Continued)

Other Income (Continued)

Interest Income consists of interest earned on the Commission's cash balances, which are invested in short-term, highly liquid investments. Declines in interest income reflect the general decline in interest rates over the past two years.

Net increase/(decrease) in fair value of investments reflects the change in the market value of U.S. Treasury securities held by the Commission to fund long term prizes.

Interest accretion represents the amortization of discount on U.S. Treasury securities purchased to fund long term prizes, adjusted for the change in fair market value of those securities. The Commission purchased securities for one additional long term prize winner during FY04 and six additional long term prize winners during FY03.

THE STATE LOTTERY COMMISSION OF INDIANA
STATEMENTS OF NET ASSETS
JUNE 30, 2004 AND 2003

	2004	2003
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents (Notes 1 and 2)	$ 58,893,255	$ 42,977,623
Current portion of investments (Notes 1 and 2)	11,913,680	13,215,043
Accounts receivable, less allowance of $2,027,765 and $2,391,425, respectively (Note 1)	26,191,944	30,407,287
Instant ticket inventory (Note 1)	314,037	641,493
Prepaid expenses	1,236,017	876,508
Accrued interest receivable	143,555	101,717
Total Current Assets	98,692,488	88,219,671
NONCURRENT ASSETS		
Restricted Assets (Note 6)	9,740,494	10,793,503
Long-term Investments, less current portion above (Notes 1 and 2)	56,908,241	58,491,055
Capital Assets (Notes 1 and 3)		
Vehicles	2,043,017	1,807,868
Furniture, fixtures and equipment	7,060,682	7,036,095
Data processing equipment	7,878,698	7,621,878
Accumulated depreciation	(13,019,945)	(11,770,015)
Total Noncurrent Assets	70,611,187	73,980,386
TOTAL ASSETS	169,303,675	162,200,057
LIABILITIES		
CURRENT LIABILITIES		
Accounts payable		
Trade	4,739,560	6,101,627
State (Note 1)	30,859,218	34,783,065
State Pensions (Note 1)	15,000,000	15,000,000
Current portions of accrued prize liability (Notes 1 and 4)	54,752,082	44,094,762
Deferred on-line game revenue	319,588	1,174,977
Other accrued expenses	2,207,654	1,597,945
Total Current Liabilities	107,878,102	102,752,376
LONG-TERM LIABILITIES		
Long-term portions of accrued prize liability Less current portion above (Notes 1 and 4)	56,537,241	58,120,055
Total Noncurrent Liabilities	56,537,241	58,120,055
TOTAL LIABILITIES	164,415,343	160,872,431
NET ASSETS		
Unrestricted	925,880	(3,368,200)
Invested in capital assets	3,962,452	4,695,826
TOTAL NET ASSETS	$ 4,888,332	$ 1,327,626

The accompanying notes to the financial statements are an integral part of this statement.

THE STATE LOTTERY COMMISSION OF INDIANA
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2004 AND 2003

	2004	2003
OPERATING REVENUES		
Charges for Services		
On-line ticket sales (Note 1)	$ 293,803,444	$ 258,914,369
Instant ticket sales, net (Note 1)	441,068,792	405,503,082
Total Operating Revenues	734,872,236	664,417,451
OPERATING EXPENSES		
Game expenses		
On-line games prizes	142,892,049	124,551,557
Instant game prizes	286,711,041	258,568,651
Television game show prizes	6,928,151	13,119,169
Ticket printing costs	6,942,544	6,304,319
Advertising and promotion (Note 1)	9,452,347	10,292,443
Retailer commissions (Note 1)	50,326,569	45,529,235
On-line professional services	12,485,861	12,199,675
ITVM lease and courier services	3,140,569	2,305,350
Total game expenses	518,879,131	472,870,399
Other operating expenses		
Salaries, wages and benefits	13,244,847	12,449,667
General and administrative	4,459,719	4,717,531
Total other operating expenses	17,704,566	17,167,199
Total Operating Expenses	536,583,697	490,037,598
OPERATING INCOME	198,288,539	174,379,854
NONOPERATING REVENUES/(EXPENSES)		
Interest income	880,081	1,099,157
Net increase/(decrease) in fair value of investments	(1,309,149)	2,277,873
Interest accretion	(1,225,239)	(4,856,093)
Other income	2,690,397	2,700,933
Total Nonoperating Revenues/(Expenses)	1,036,090	1,221,870
NET INCOME PRIOR TO DISTRIBUTIONS	199,324,629	175,601,724
Distributions to the State Pensions (Note 1)	(45,000,000)	(45,000,000)
Distributions to the State (Note 1)	(103,104,705)	(84,102,076)
Distributions to the State Budget Agency (Note 1)	(1,800,000)	-
Distributions to be paid to the State Pensions (Note 1)	(15,000,000)	(15,000,000)
Distributions to be paid to the State (Note 1)	(30,859,218)	(34,783,065)
Total Distributions	(195,763,923)	(178,885,142)
Changes in Net Assets	3,560,706	(3,283,418)
Total Net Assets - beginning	1,327,626	4,611,044
Total Net Assets - ending	$ 4,888,332	$ 1,327,626

The accompanying notes to the financial statements are an integral part of this statement.

THE STATE LOTTERY COMMISSION OF INDIANA
STATEMENTS OF CASH FLOWS
FOR THE YEAR ENDING JUNE 30, 2004 AND 2003

	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from ticket sales	$ 738,937,625	$ 652,562,728
Payments to ticket winners	(427,545,158)	(389,235,168)
Payments to employees	(12,635,138)	(12,737,487)
Payments to suppliers	(86,540,727)	(82,753,862)
NET CASH PROVIDED BY OPERATING ACTIVITIES	212,216,602	167,836,211
CASH FLOWS FROM INVESTING ACTIVITIES		
Net proceeds (purchases) of investments	349,789	875,066
Interest income	838,243	1,332,559
NET CASH PROVIDED BY (USED FOR) INVESTING ACTIVITIES	1,188,032	2,207,625
CASH FLOWS FROM NONCAPITAL AND RELATED FINANCING ACTIVITIES		
Distributions to the State	(153,545,922)	(123,727,066)
Distributions to the State Budget Agency	(1,800,000)	-
Distributions to the State Pensions	(45,000,000)	(45,000,000)
Other Income	2,690,397	2,700,933
Net (increase) decrease in Restricted Assets	1,053,009	(226,816)
NET CASH PROVIDED BY (USED FOR) NONCAPITAL AND RELATED FINANCING ACTIVITIES	(196,602,516)	(166,252,949)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Purchase of fixed assets	(934,370)	(4,752,944)
Proceeds from the sale of fixed assets	47,884	36,847
NET CASH PROVIDED BY (USED FOR) CAPITAL AND RELATED FINANCING ACTIVITIES	(886,486)	(4,716,097)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	15,915,632	(925,210)
CASH AND CASH EQUIVALENTS - Beginning of year	42,977,623	43,902,833
CASH AND CASH EQUIVALENTS - End of year	$ 58,893,255	$ 42,977,623

The accompanying notes to the financial statements are an integral part of this statement.

THE STATE LOTTERY COMMISSION OF INDIANA
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDING JUNE 30, 2004 AND 2003

	2004	2003
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES:		
Operating income	$ 198,288,539	$ 174,379,854
Adjustments to reconcile operating income to net cash from operating activities:		
Depreciation	1,661,000	1,479,217
Change in provision for doubtful accounts	19,256	(35,685)
Change in provision for ticket returns	382,916	359,736
Gain on sale of fixed assets	(41,141)	(37,206)
(Increase) decrease in assets:		
Accounts receivable	4,579,003	(12,948,953)
Instant ticket inventory	327,456	(480,717)
Prepaid expenses and other assets	(359,508)	(328,315)
Increase (decrease) in liabilities:		
Accounts payable - trade	(1,362,066)	(2,075,493)
Deferred on-line game revenue	(855,389)	807,383
Other accrued expenses	609,709	(287,820)
Accrued prize liability	8,966,826	7,004,210
NET CASH FLOWS PROVIDED BY OPERATING ACTIVITIES	$ 212,216,602	$ 167,836,211

The change in fair value of investments and interest accretion that was not cash was $(1,309,149) and $2,277,873, respectively.

The accompanying notes to the financial statements are an integral part of this statement.

THE STATE LOTTERY COMMISSION OF INDIANA
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED JUNE 30, 2004

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICES

Organization - The State Lottery Commission of Indiana (the "Commission") was established by Public Law No. 341, as amended, as listed in Indiana Code Section 4, Article 30 in May 1989 (Lottery Article). The Commission has introduced various draw games since its inception, including Hoosier Lotto, Powerball, Daily 3, Daily 4, Lucky 5, 5 Card Cash, Max 5, and various scratch-off and pull tab ticket games.

Reporting Entity – The Commission is a component unit of the State of Indiana (the "State") and is reported as an enterprise fund in the State's Comprehensive Annual Financial Report (CAFR).

Basis of Accounting – The Commission's financial statements are prepared on the full accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. Revenues are recognized when they are earned; expenses are recognized when incurred. Scratch ticket revenue less an allowance for ticket returns is recognized at the time tickets are ordered by licensed retailers. Ticket revenue for draw games is recognized in the period in which tickets sold to the playing public become eligible for a drawing. Certain scratch ticket games include free ticket prizes that entitle the holder to exchange one ticket for another of equal value. The selling price of free tickets reduces scratch ticket revenue when tickets are issued to retailers.

Operating revenues of the Commission consist of sales of scratch, pull tab and draw game lottery tickets. Operating expenses of the Commission consist of game related prize payments, as well as the administrative costs incurred in the operations of the Commission. All other items are considered nonoperating revenues and expenses.

The Commission has applied all FASB Statements and Interpretations, Accounting Principles Board Opinions and Accounting Research Bulletins, except for those that conflict with or contradict GASB pronouncements.

Cash and Cash Equivalents – Cash and cash equivalents consist of cash on deposit and short-term, highly liquid investments, maturing in three months or less. Included in cash and cash equivalents are investments in direct obligations of the U.S. government or government agencies, perfected repurchase agreements, AAA/AA short-term commercial paper or various money market funds composed exclusively of investment vehicles previously described. At times, cash deposits may be in excess of the federally insured limits.

Investments – The Treasurer of the State, on behalf of the Commission, is permitted to invest Commission funds in direct obligations of the U.S. Treasury or insurance annuities to fund future installment prize obligations. Investments are recorded at fair value, except for the insurance annuities, at June 30, 2004 and 2003. The insurance annuities are considered to be non-participating interest-earning contracts and are carried at cost.

Allowance for Ticket Returns – Allowance for ticket returns is based on historical experience associated with scratch game ticket returns.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICES (Continued)

Allowance for Doubtful Accounts – Allowance for doubtful accounts is based on management's estimate of retailer receivables that will not be collected.

Fixed Assets – Capital assets are stated at cost. Capital assets are defined as assets that have a useful life of more than one year and a unit cost of more than $300. Depreciation is computed using the straight-line method over the estimated lives of the assets. Vehicles are depreciated over five years; data processing equipment and software are depreciated over three to five years; all other assets are depreciated over five years. Depreciation expense was $1,661,000 and $1,479,217 for the years ended June 30, 2004 and 2003, respectively.

Ticket Inventory – Ticket inventory as stated on the June 30, 2004 Statement of Net Assets consists of scratch tickets and pull tabs purchased by the Commission under an agreement for new games that are not yet on sale to retailers. These inventories are carried at cost, using the specific identification method. Tickets are charged to cost of tickets sold upon order by licensed retailers.

During fiscal year 2002, the Commission entered into an agreement with its primary scratch ticket vendor whereby the Commission only pays for scratch tickets issued to and sold by Commission retailers. Any scratch tickets not issued to retailers for sale or any tickets not sold by retailers are not paid for by the Commission. Based upon the new agreement, the Commission does not have any risk of loss in the event the tickets become damaged or lost, as the tickets have not been sold. Therefore, scratch tickets purchased under this agreement are not treated as inventory by the Commission.

Accrued Prize Liability – Accrued prize liability includes an estimate of unclaimed scratch, pull tab and draw game winners and future television game show prizes awarded on shows committed to as of June 30, 2004 and 2003, as well as installment amounts payable to past scratch, pull tab, draw game and game show winners. Installment prizes are recorded at a discount based on interest rates that range from approximately 2% to 6% and reflect the interest earned by the investments held to fund the related liabilities.

For scratch and pull tab games, a liability is recorded when licensed retailers order tickets. The accrual is based on the specified prize payout structure established for each game. All prizes must be claimed within 60 days after the declared end-of-game date or they will be forfeited. The liability for draw games is determined based on the actual winning numbers drawn and the number of wagers placed for each draw date. All draw game prizes must be claimed within 180 days of the date of the selection event or they will be forfeited. All unclaimed prize money is added to a pool from which future prizes are to be awarded or from which the cost of prize promotions can be paid.

Net Assets – As stated in the Lottery article, funds in excess of the amounts necessary to pay prizes and expenses for the operation of the Commission are to be distributed quarterly per a statutory schedule to the State Treasurer. The Commission has set aside amounts that it estimates necessary to meet future cash flow needs of the Commission until the next transfer to the State Treasurer. These amounts have been reflected in the accompanying financial statements as Unrestricted Net Assets.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICES (Continued)

Net Assets (Continued)
The Lottery Article requires that the State Treasurer distribute $30 million annually to the Indiana State Teacher's Retirement Fund to pay a portion of the current pension obligations, and $30 million annually to the State Pension Relief Fund to assist cities and towns in the payment of current and future pension obligations. During this fiscal year $1.8 million was distributed to the State Budget Agency in order to provide a match for federal funds received under the Help America Vote Act. The balance of the amount distributed to the State Treasurer is deposited into the State's Build Indiana Fund, to be distributed to state and local capital projects and for the Lottery/Gaming Surplus Account. Distributions to the State's Build Indiana Fund totaled $133,963,923 and $118,885,141 for the years ended June 30, 2004 and 2003, respectively.

Net assets invested in capital assets, consists of capital assets, net of accumulated depreciation.

Commissions – Retailers earn a 5.5% sales commission on draw game and scratch tickets, a 6% sales commission on draw game tickets and a 7% sales commission on pull tab tickets. Retailers earn a 1% cashing commission for redeeming winning tickets and the lesser of 1% or $100,000 for selling winning jackpot tickets. Additionally, retailers are eligible for a quarterly bonus based on their scratch and pull tab sales over the preceding thirteen week period.

Budget – As stated in the Lottery Article, the Commission shall submit a detailed budget to the Budget Agency and each legislative member of the budget committee, when requested by the Agency, on forms prescribed by the Budget Agency. The budget committee has not requested a budget to date; however, the Commission prepares an annual budget that is reviewed and approved by the Director for internal purposes. The Commission is not required to adopt a legal budget and does not do so; therefore, no budgetary comparison is included in these financial statements.

Use of Estimates – Preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities. Disclosure of contingent assets and liabilities at the date of the financial statements, the reported amounts of revenues and accrued prize liability and the allowance for ticket returns also involve reliance on management's estimates. Actual results could differ from those estimates.

2. DEPOSITS AND INVESTMENTS

Deposits
The Commission's investment policy establishes cash and investment guidelines for the deposit of funds. The Commission is authorized to make deposits in commercial banks and savings and loan institutions, obligations of the U.S. Treasury and U.S. Agencies, money market funds with portfolios of securities issued or guaranteed by the United States or agreements to repurchase these same obligations, repurchase agreements and short term commercial paper rated AAA or AA.

2. DEPOSITS AND INVESTMENTS (Continued)

Deposits (Continued)

The carrying amount of the Commission's deposits with financial institutions at year-end 2004 and 2003 totaled $(39,119) and $(681,216) respectively, while bank balances totaled $365,976 and $568,717, respectively. The bank balances are categorized as follows:

	June 30, 2004	June 30, 2003
Insured by the FDIC or collateralized with securities held by the Commission in its name	$ 126,020	$ 106,514
Uncollateralized or uninsured	239,956	462,203
Total deposits	$ 365,976	$ 568,717

Investments

The Lottery Article states that money that the Commission anticipates will be available for the payment of prizes on a deferred basis may be invested in direct U.S. Treasury obligations or insurance annuities. Investments are reported at fair value, except for insurance annuities, using quoted market prices. Insurance annuities are carried at cost. Changes in the fair value of the investments are recognized as revenue or expense in the operating statement. The net increase (decrease) in the fair value of the investments affecting operations for the year ended June 30, 2004 and 2003 was $(1,309,149) and $2,277,873, respectively. Investments in insurance annuity contracts relate to deferred prize obligations at rates yielding approximately 2% to 6%

The Commission's outstanding investments are classified as to credit risk by the three categories described below.

Category 1 – Insured or registered, or securities held by the Commission or its agent in the Commission's name

Category 2 – Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the Commission's name

Category 3 – Uninsured and unregistered, with securities held by the counterparty, its trust department or agent, but not in the Commission's name

The Commission's investments are categorized as follows:

	Category 1	Category 2	Category 3	Carrying Amount	Fair Value
U.S. Gov't Securities	$ -	$ -	$ 30,766,624	$ 30,766,624	$ 30,766,624
Commercial Paper	-	-	1,499,175	1,499,175	1,499,175
Repurchase Agreements	-	-	472,923	472,923	472,923
	$ -	$ -	$ 32,738,722		
Money Market Funds				52,913,503	52,913,503
Insurance Annuities				42,574,993	44,957,857
Total Investments				$ 128,227,218	$ 130,610,082

2. DEPOSITS AND INVESTMENTS (Continued)

A reconciliation of cash, cash equivalents and investments per the balance sheet to the deposits and investments presented above is as follows:

Balance Sheet	
Cash and Cash Equivalents	$ 58,893,255
Investments (current)	11,913,680
Investments (long-term)	56,908,241
Restricted Assets	472,923
Total	$ 128,188,099
Footnotes	
Deposits	$ (39,119)
Investments (current and long-term)	128,227,218
Total	$ 128,188,099

3. CAPITAL ASSETS

A summary of the Commission's capital assets at June 30, 2004 is as follows:

	Balances at June 30, 2003	Increases	Decreases	Balances at June 30, 2004
Vehicles	$ 1,807,868	$ 652,963	$ (417,814)	$ 2,043,017
Furniture, fixtures and equipment	7,036,095	24,587	-	7,060,682
Data processing equipment	7,621,878	256,820	-	7,878,698
Total capital assets, being depreciated	16,465,841	934,370	(417,814)	16,982,397
Less Accumulated Depreciation:				
Vehicles	(1,179,246)	(252,044)	411,070	(1,020,220)
Furniture, fixtures and equipment	(4,102,980)	(736,407)	-	(4,839,387)
Data processing equipment	(6,487,789)	(672,549)	-	(7,160,338)
Total Accumulated Depreciation	(11,770,015)	(1,661,000)	411,070	(13,019,945)
Total capital assets, net	$ 4,695,826	$ (726,630)	$ (6,744)	$ 3,962,452

4. ACCRUED PRIZE LIABILITY

The accrued prize liability related to past game show and on-line winners, including an estimate of unclaimed instant and on-line winners and future game show prize awards is as follows:

	June 30, 2004	June 30, 2003
TV game show and Hoosier Lotto liability	$ 62,328,241	$ 63,763,055
Future TV Game Show Accrued	237,794	244,374
Scratch game liability	32,965,386	27,211,464
Pull tab game liability	1,788,799	1,995,307
On-line game liability	13,889,221	8,250,529
Unclaimed prize liability	79,882	750,088
Total accrued prize liability	111,289,323	102,214,817
Less current portion	(54,752,082)	(44,094,762)
Non-current portion	$ 56,537,241	$ 58,120,055

Long-term and short term liability activity was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Accrued Prize Liability:				
Long-Term	$ 58,120,055	$ 3,649,677	$ (5,232,491)	$ 56,537,241
Short-Term	44,094,762	54,752,082	(44,094,762)	54,752,082
Total	$ 102,214,817	$ 58,401,759	$(49,327,253)	$ 111,289,323

The amount due within one year is: $54,752,082 and the amount due thereafter is $56,537,241.

Liabilities for future payments is as follows:

Fiscal years ending June 30,	TV Game Show and Hoosier Lotto	Other Accrued Prize Liability	Total
2005	$ 6,028,794	$ 48,723,288	$ 54,752,082
2006	5,791,000	-	5,791,000
2007	5,791,000	-	5,791,000
2008	5,791,000	-	5,791,000
2009	5,791,000	-	5,791,000
2010 – 2014	26,935,000	-	26,935,000
2015 – 2019	21,405,000	-	21,405,000
2020 – 2024	16,653,000	-	16,653,000
2025 – 2028	4,328,000	-	4,328,000
Total	98,513,794	48,723,288	147,237,082
Less unamortized discount	(35,947,759)	-	(35,947,759)
Total at present value	62,566,035	48,723,288	111,289,323
Less current portion	(6,028,794)	(48,723,288)	(54,752,080)
Total long-term portion at present value	$ 56,537,241	$ -	$ 56,537,241

Accrued prize liability installments are discounted to their present value at date of award. This discounted value approximates fair value. Interest is not paid on prizes.

5. LEASES

The Commission leases office space in each of its eight regions and at headquarters located in Indianapolis. The office space leases at the regions are for periods up to five years and the headquarters office space lease is for up to ten years. In addition, the Commission has leased warehouse space for its ticket inventory for a period up to five years and parking facilities for the Indianapolis location on an annual basis. There are also several office equipment leases ranging from two to five year terms, including a scratch-off ticket vending machine lease. Total rental expense was approximately $2,922,907 and $2,743,259 for the years ended June 30, 2004 and 2003, respectively.

The future minimum rental payments required under operating leases that have initial or remaining non-cancelable lease terms in excess of one year is as follows:

Fiscal years ending June 30,

2005	$ 742,146
2006	621,424
2007	514,577
2008	428,405
2009	376,164
2010 – 2014	1,863,411
Total	$ 4,546,127

6. COMMITMENTS AND CONTINGENCIES

The Commission is a member of the Multi-State Lottery Association (MUSL), an unincorporated government-benefit voluntary association created for the purpose of administering joint lottery games. MUSL currently consists of 28 state and district lotteries (member lotteries) and operates the on-line Powerball game. Under separate agreements between MUSL and each lottery, the member lotteries sell tickets for this game and remits 50 percent of sales to prize winners or to MUSL for payment of prizes.

As a member of MUSL, the Commission is required to contribute to various prize reserve funds held by MUSL. The prize reserve account was established by MUSL as a contingency reserve to fund prizes in excess of the game set prize structure for low-tier prizes and to protect all member lotteries and MUSL from any unforeseen liabilities. All funds remitted, and the related interest earned, will be returned to the Commission upon leaving MUSL, less any portion of unanticipated prize claims that may have been paid from the funds. As of June 30, 2004 and 2003, the Commission's balance of prize reserve funds was $9,267,571 and $10,290,842 respectively.

Restricted assets also contain the Retailers Bonding Fund, with a balance as of June 30, 2004 and 2003 of $472,923 and $502,661, respectively.

7. RETIREMENT PLAN

Defined benefit pension plan – The Commission has adopted a single-employer defined benefit pension plan. Article 30 of the state statute of Indiana assigns the Commission to establish and amend benefit provisions. An independent contractor administers the Employees' Pension Plan of the State Lottery Commission of Indiana (the "Plan.") The Plan covers virtually all of the Commission's full time employees over the age of twenty-one, providing retirement, death, and disability benefits. Upon employee retirement at age 65, the Plan provides annual benefits equal to 2% of an employee's average salary earned during the highest five consecutive years of employment multiplied by the number of full-time years of employment up to a maximum of 25 years. Participants become fully vested after 4 years of service. Employees cannot contribute to the plan, thus there is no required contribution for active plan members.

The Commission has adopted Governmental Accounting Standards Board Statement No. 27 (GASB No. 27), "Accounting for Pensions by State and Local Governmental Employers." GASB No. 27 requires that the measurement of pension expense for a period be similar to the required contributions for that period and related information reported be consistent. The resulting pension liability (asset) to comply with the provisions of GASB No. 27 was determined in accordance with this statement.

The Commission's annual pension cost and net pension obligation to the Plan for the plan year ended December 31, 2003, 2002 and 2001 is as follows:

	2003	2002	2001
Annual required contribution	$ 693,040	$ 599,280	$ 589,280
Interest on net pension obligation	(7,491)	(3,335)	(1,875)
Adjustment to annual required contribution	(10,564)	(4,704)	(2,645)
Annual pension cost	696,113	600,649	590,050
Contributions made	716,590	652,596	608,300
Increase (decrease) in net pension obligation	(20,477)	(51,947)	(18,250)
Net pension obligation, beginning of year	(93,636)	(41,689)	(23,439)
Net pension obligation (asset), end of year	$ (114,113)	$ (93,636)	$ (41,689)
Percentage of annual pension cost contributed	103.4%	108.9%	103.2%

The annual required contribution and contribution rate for the current year was determined as part of the January 1, 2004 actuarial valuation using the frozen entry age actuarial cost method. The employer rate for calendar year 2003 was 8.1% of payroll. The actuarial assumptions included an 8.0% investment rate of return and no projected increases in salary, post-retirement benefit increases or inflation components. The amortization method used is a level percentage of projected payroll on a closed basis over 30 years. The actuarial value of assets was determined using market value.

7. RETIREMENT PLAN (Continued)

The Commission's six-year trend information, by Plan year, is as follows:

Plan Year	Annual Required Contribution	Actual Employer Contribution	Percentage Contributed	Net Pension Obligation
1998	$ 420,853	$ 427,962	101.7%	$ (14,936)
1999	550,654	556,700	101.1%	(20,492)
2000	604,680	608,300	100.6%	(23,439)
2001	589,280	608,300	103.2%	(41,689)
2002	599,280	652,596	108.9%	(93,636)
2003	693,040	716,590	103.4%	(114,113)

8. RISK MANAGEMENT

The Commission is covered by commercial insurance for exposures to loss or abandonment of property, automobile liabilities, fiduciary responsibilities for the employee pension fund, employee dishonesty, forgery, bodily injury, worker's compensation, property damage, and an umbrella coverage insurance policy and media coverage of its television show. The Commission also provides its employees with health and dental insurance coverage. The premiums for this coverage are based upon the type of plan provided and are paid by the Commission and/or Commission employees, also based on the type of coverage. The Commission has not had any significant settlements exceeding its insurance coverage in any of the past three fiscal years. There were no significant reductions in its insurance coverage in the current year.

9. LITIGATION

During 1997, a suit was filed in Marion County Court seeking class action status on behalf of all persons denied prizes on tickets submitted beyond the final sixty-day (60) claim period. Although the trial court granted the Commission's motion to dismiss the case, the Indiana Court of Appeals reversed that decision and ruled that the plaintiff was entitled to a trial on the merits. The Indiana Supreme Court chose not to alter the appellate decision thereby returning the matter to the original court for trial.

In July 2003, the trial court conditionally certified two classes: (1) Class A, a class of all persons who, prior to 1997, purchased and presented winning instant tickets for payment after the sixty (60) day claim period and were denied the associated prizes; and (2) Class B, a class of all persons who, prior to 1997, purchased winning instant tickets and have never presented the tickets for payment.

In October, 2003, the trial court granted the Commission's motion for summary judgment, thereby dismissing the action. Subsequently, the Court of Appeals reversed the lower court and reinstated the case regarding Class A and affirmed the lower court in dismissing Class B. The plaintiffs have asked the Court of Appeals to reconsider their decision regarding Class B.

9. LITIGATION (Continued)

Management and its legal counsel intend to vigorously defend the Commission's position and believe the Commission will prevail. However, the Commission cannot predict the final resolution of this matter or whether its resolution could materially affect the Commission's results of operations, cash flows or financial position.

THE STATE LOTTERY COMMISSION OF INDIANA

REQUIRED SUPPLEMENTARY INFORMATION

Schedule of Funding Progress for Pension Plan

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuary Accrued Liability (AAL) Entry Age (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
1/1/99	$ 4,585,243	$ 4,614,501	$ 29,258	99.4%	$ 7,099,942	0.4%
1/1/00	4,987,986	5,000,399	12,413	99.8%	7,204,319	0.2%
1/1/01	5,958,506	7,367,872 **	1,409,366	80.9%	7,595,329	18.6%
1/1/02	6,922,670	8,308,021	1,385,351	83.3%	8,072,437	17.2%
1/1/03	7,650,486 *	9,012,069	1,361,583 *	84.9% *	8,770,313	15.5% *
1/1/04	7,673,634	9,362,428	1,688,794	82.0%	8,395,882	20.1%

* Revised figures reflect a difference between the final 2002 contribution and the contribution that was expected at the time the January 1, 2003 Valuation was completed.

** Increase in Actuary Accrued Liability (AAL) Entry Age (b) due to change in vesting schedule.

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REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

TO THE STATE LOTTERY COMMISSION OF INDIANA
AND THE STATE BUDGET AGENCY OF INDIANA

We have audited the basic financial statements of the State Lottery Commission of Indiana (Commission) as of and for the year ended June 30, 2004, and have issued our report thereon dated September 9, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Commission's basic financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.*

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Commission's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the basic financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the State Lottery Commission of Indiana, the State Budget Agency of Indiana and management and is not intended to be and should not be used by anyone other than these specified parties.

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Oak Brook, Illinois
September 9, 2004

Chicago · Oak Brook · Springfield · New York · Indiana